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The Employee Share Trust: Establishing A Dynamic Market For Your Employee Share Schemes

Webinar

Monday 29 June 2020

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A Word From The Chairman

Ian Harris, BA (Hons) FCA FBCS FIBC CMC

Managing Director

Z/Yen Group






Agenda

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12:00 – 12:05	Chairman's Introduction
12:05 – 12:25	Keynote address
12:25 – 12:30	Final thoughts
12:30 – 12:45	Questions & Answers

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The Employee Share Trust: Establishing A Dynamic Market For Your Employee Share Schemes

David Craddock

Founder and Director

David Craddock Consultancy Services

David Craddock Consultancy Services

DAVID CRADDOCK CONSULTANCY SERVICES

Specialist in Employee Share Ownership and Reward Management,
Management Buyouts, Share Valuation
and Investment Education

The Historical Employee Share Trust

What is the historic concept of the employee share trust?

- Historically the employee share trust is typically resident for tax purposes in an offshore jurisdiction, say for example Jersey or Guernsey or the Isle of Man. This is the arrangement that is created from the general legislation rather than bespoke legislation and is referred to in this presentation as "the historical employee share trust".

What is the history of this employee share trust structure?

- The origins of this structure lie in the solution provided by Louis Kelso in 1956 for Peninsula Newspapers, a company based in Palo Alto, California. The challenge was that the owner wished to retire and sell his shares to the employees while the employees, despite their willingness to buy, did not have the cash to enter into the transaction.

What is the significance of the Peninsula Newspapers case?

- The case established the basis for a management-employee buyout arrangement. The trust dispenses the shares to the employees through bona fide employee share schemes. However, the trust has a dual function in that it also buys back the shares from the employees for subsequent recycling when the employees sell. In the absence of a recognised stock exchange, the trust operates a market for the shares.
- The case also established the express linkage in the US between succession planning and pension provision for retirement as the employees sell their shares back to the trust on retirement.

How does the employee share trust work and what is the basis for financing?

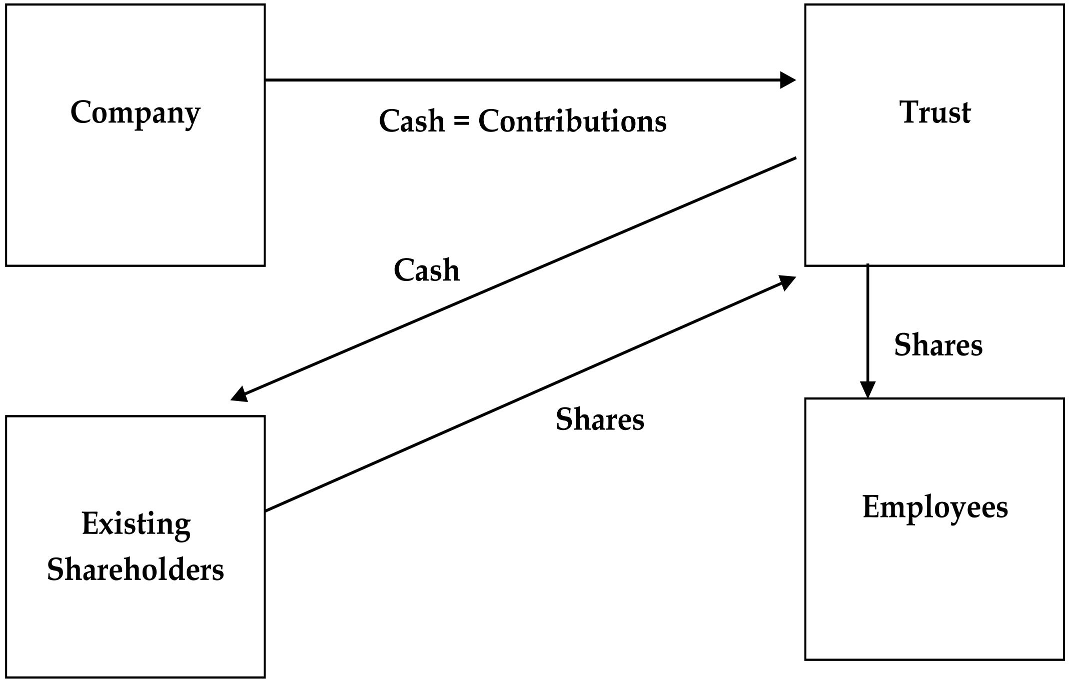
- The following set of seven diagrams depict the application of the key trust principles that operate for purposes of the arrangement and the financing techniques that are used to facilitate its operation. In the absence of a recognised stock exchange, the level of the finance is based on the allocation of recognised share valuation methodologies to determine the share price equivalent that is used in the transaction.

Employee Share Trusts

Diagram 1a: Company Funding through Contributions

How to Fund Free Shares: Company Contributions

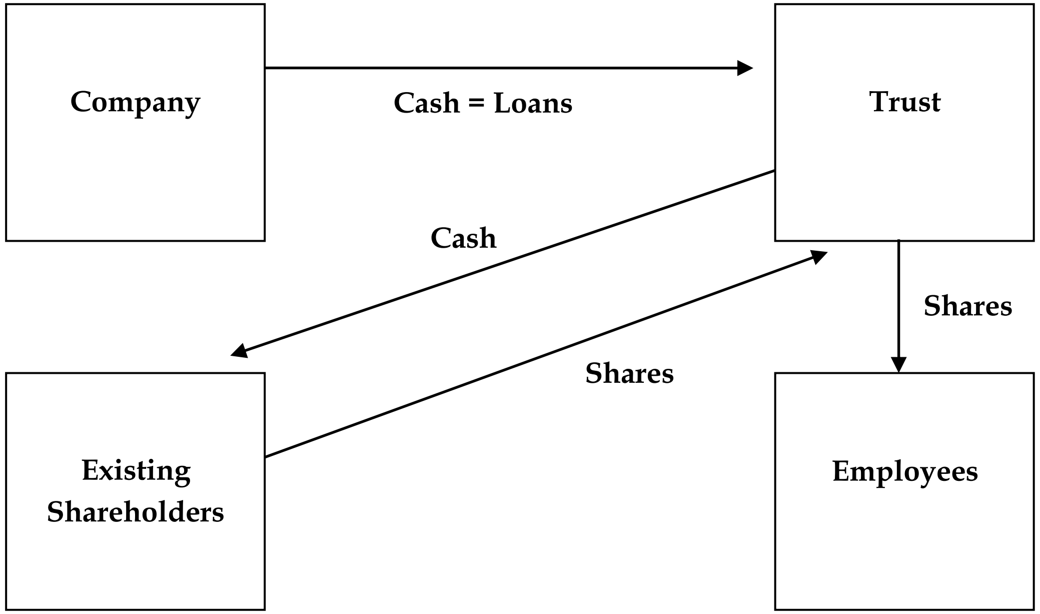
- If the company, rather than an external financial institution, is to fund the trust then the alternatives available are either funding through gift contributions or funding through loans.
- Where loans are advanced by the company to the trust, it is, of course, possible at a later stage for the company to make contributions to the trust so that with a circular movement of cash the trust in a position to pay off the loans.



Employee Share Trusts

Diagram 1b: Company Funding through Loans

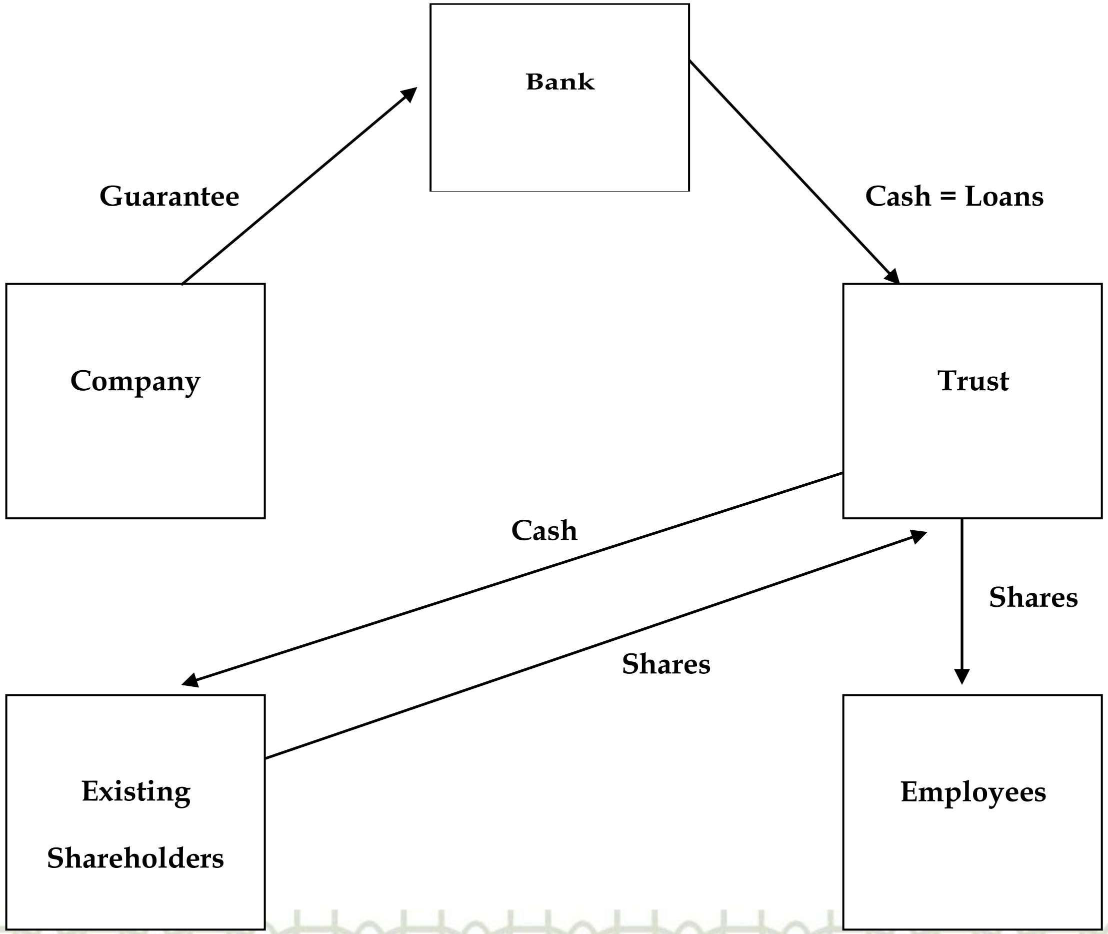
How to Fund Option Shares: Company Loans



Employee Share Trusts

Diagram 2: Bank Funding through Company Guarantees

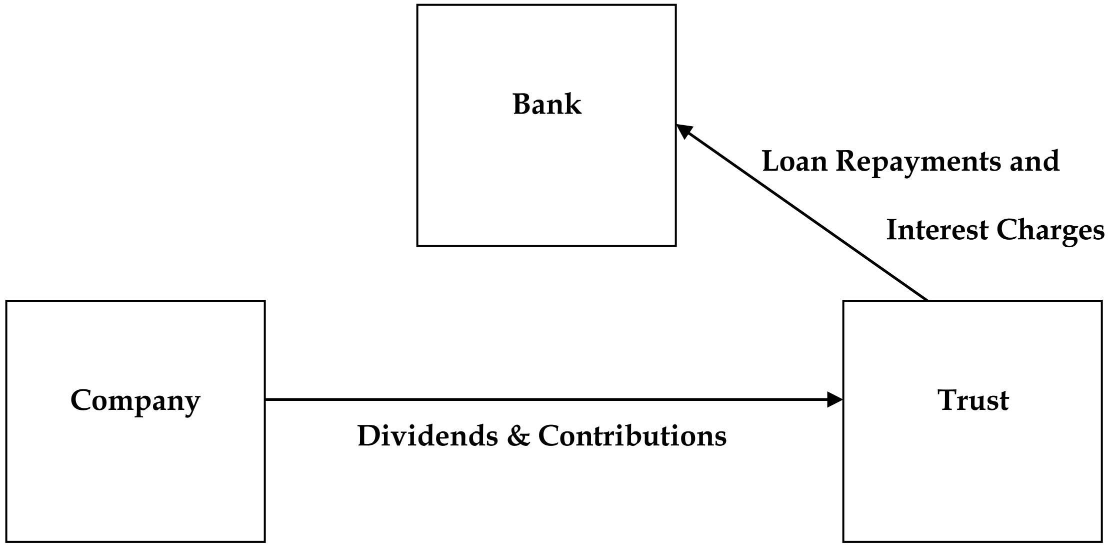
- If the company is "cash poor but asset rich" it may be necessary and possible for an external financial institution to fund the trust on the basis of guarantees given by the company. In these circumstances, both the company and the trust are parties to the agreement with the external financial institution.



Employee Share Trusts

Diagram 3: Funding the Loan Repayments and Interest Charges

- Where funding is obtained from an external financial institution, the trust will have to pay interest charges to the external financial institution. In these circumstances, the trust deed will not usually contain a dividend waiver so that dividends received on shares can contribute to the payment of the interest charges. The rest of the funding for the loan repayments and the payment of interest charges will derive from company contributions to the trust.

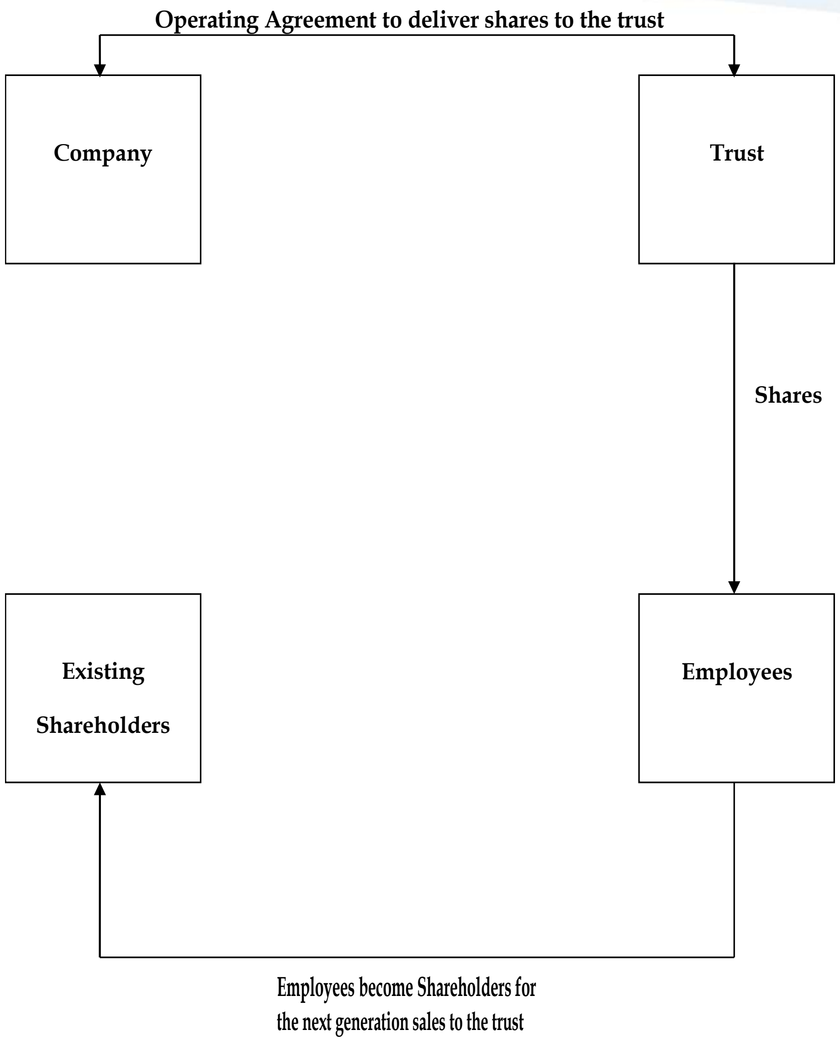


Employee Share Trusts

Diagram 4: Employees become Shareholders through the Transfer of Trust Shares

- Once the employees become shareholders through, typically, either the exercise of share options or an award of shares then, for purposes of selling their shares, they move in the diagrammatical representation from the bottom right-hand box to the bottom left-hand box.

- The illustrates the principle of how the shares are recycled from one generation of shareholders to the next generation of shareholders.

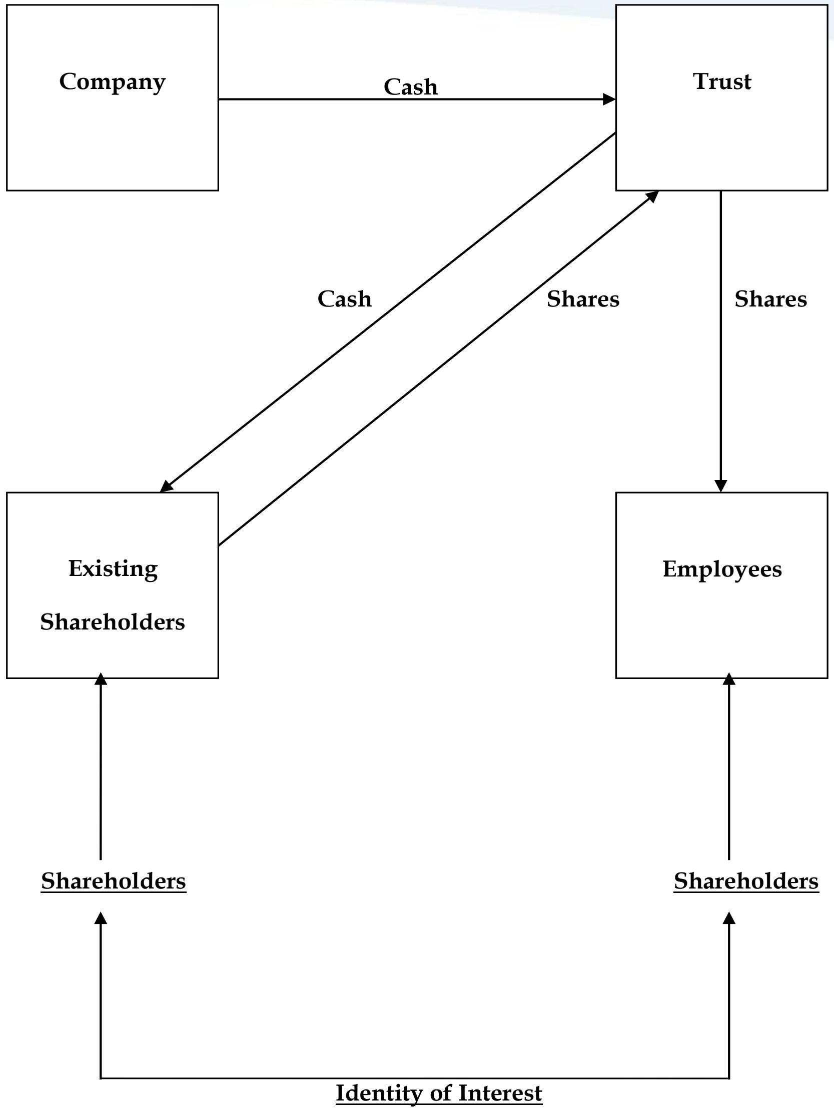


Employee Share Trusts

Diagram 5: Identity of Interest

- Although the term "identity of interest" is not a legal term of art, it is a well-established term in employee share scheme parlance. It is based on the principle that existing shareholders, through their shareholdings, and employees, through their share scheme involvement, unite around the totem of the share price/value in the interest of both parties wanting to see the capital growth of the company for the reason that both parties do, indeed, have an express interest in that growth.

- The key principle that underpins the employee share ownership initiative is that employees are more likely to work towards the capital development of the company if they have an interest in the growth that supports the capital development of the company.

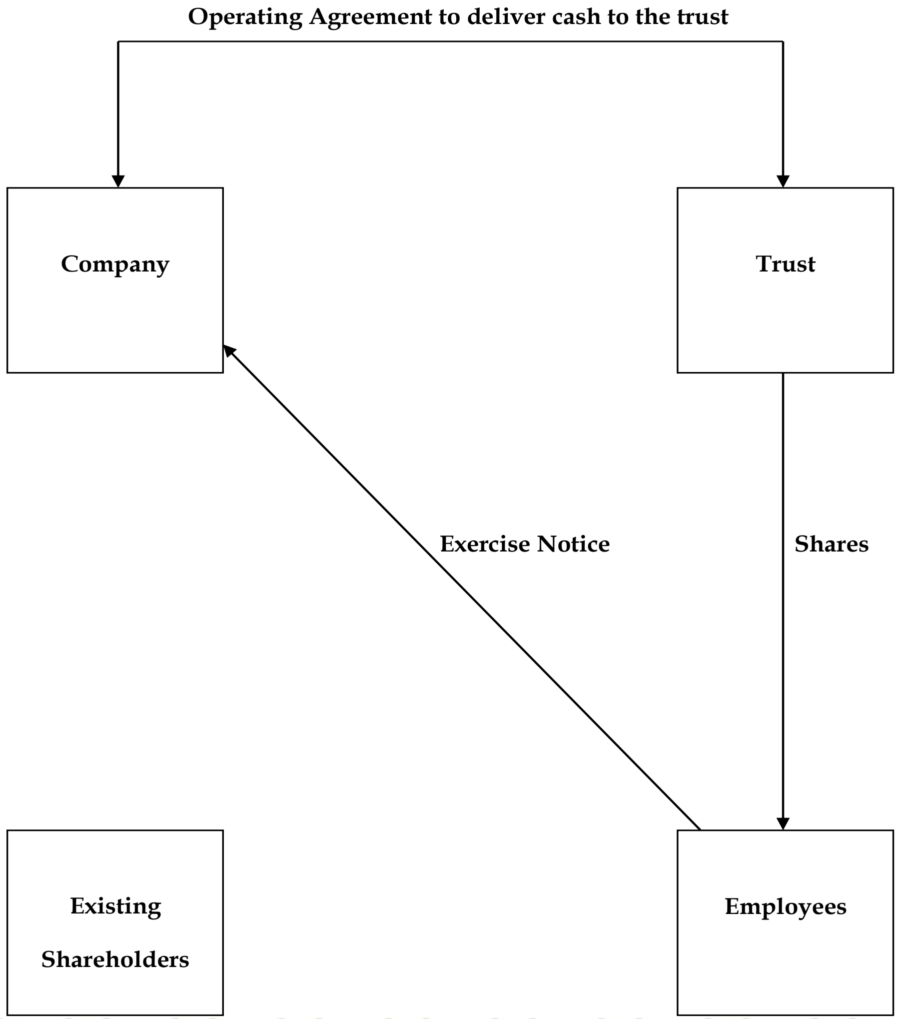


Employee Share Trusts

Diagram 6: The Operating Agreement

- The operating agreement or linking agreement (as distinct from the trust deed) governs the operating relationship between the company and the trust.

- Under the operating agreement, the trust agrees to dispense shares to the employees on the recommendation of the company, provided the company has arranged for cash to be supplied to the trust so that the trust is in a position to first buy shares that it will subsequently dispense.

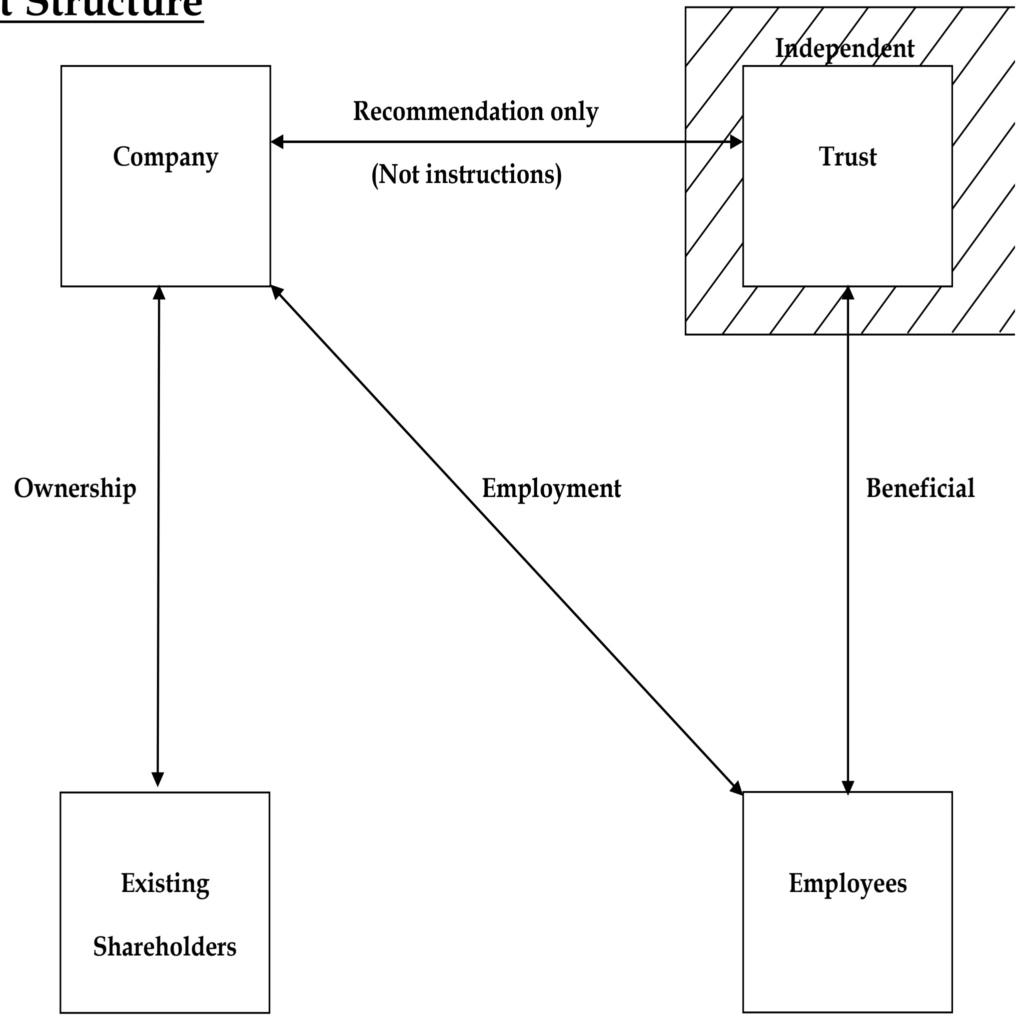


Employee Share Trusts

Diagram 7: The Relationship within the Trust Structure

- The company can provide recommendations to the trustees for use of trust property. However, these recommendations are not instructions and the trustees must operate as independent trustees, acting in the best interests of the beneficiaries.

- However, the company, as the settlor of the trust and the employer of the beneficiaries, must continue to be acutely aware of the decisions and the activities of the trustees.



The Historical Employee Share Trust

What is the tax position for each party arising from this employee share trust structure?

- **For the company**

For the company, there is no corporation tax deduction on any contribution to the trust; rather under Chapters 2 and 3 of Part 12 of the Corporation Tax Act 2009, there is corporation tax deduction on the value of any income gain in the hands of the employee. The corporation tax deduction becomes a component of the company's business profit or loss for the year and is treated like any other deductible amount that has contributed to producing profits assessable to corporation tax. Under the Part 12 rules, the gain has the potential at least to be considerably higher than the actual cost of the purchase of the shares by an employee share trust for the reason that the gain represents a market-generated gain.

- **For the employee share trust**

For the employee share trust, given that the trust and the trustees are not resident in the UK, any sales, gifts or transfer of shares from the trust to any party are not subject to capital gains tax. There is no requirement, therefore, for the trust to be supplied with funds to pay a capital gains tax liability.

- **For the employees**

For the employees, the delivery of shares to them is through bona fide employee share schemes with whatever attendant tax reliefs are attached to those employee share schemes, either through the tax reliefs that arise from the tax-advantaged scheme in Part 7 of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA 2003") or from the general tax legislation.

The shares are "readily convertible assets" under Section 702, ITEPA 2003 by virtue of the fact that the existence of the employee share trust in itself establishes "trading arrangements" in the shares. As a consequence, any income tax on employee gains is collected through the PAYE system rather than through self-assessment and National Insurance Contributions arise.

The Employee-Ownership Trust ("the EOT")

So enter the Employee-Ownership Trust ("the EOT") in 2014!

- Unlike the historical employee share trust, the EOT does have bespoke legislation. Introduced through Schedule 37, Finance Act 2014, it came into force on 6^{th} April, 2014 through the insertion of new chapters into the Taxation of Chargeable Gains Act 1992 ("TCGA 1992") and the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA 2003").
- The inspiration for the EOT initiative appears to be the approach taken by John Lewis which historically has taken a different route to employee ownership than that which is encouraged by the tax-advantaged employee share schemes. The key feature of the EOT is the sale of the company's shares to a trust for that trust to hold the shares on a permanent basis and that clearly is inspired by the John Lewis model.
- Thankfully, though, the EOT does not preclude the operation of the tax-advantaged employee share schemes. Nevertheless, it is important to state that the EOT is a self-contained mechanism for achieving its dual purpose of facilitating a capital gains tax-free sale of a controlling interest to an employee trust while also enabling the payment of income tax-free bonuses to employees by the company.
- The EOT initiative offers a business succession model that has the capacity to operate as an alternative to a takeover trade sale of the business to an independent third-party acquiring company or a flotation on a recognised stock exchange. The prime motivation behind setting up the EOT is a combination of succession planning and securing the independence of the company. It is the case, though, that the EOT can be applied to start-up companies or, indeed, to companies at any stage in their development as indeed can wider employee share ownership in its many manifestations.

The Employee-Ownership Trust ("the EOT")

The EOT Tax Exemptions

A. Capital Gains Tax Exemption: Qualifying Disposal of Shares

- A complete exemption from capital gains tax for the seller of the shares for the sale of the 51% controlling share interest to the trustee of the EOT in that defined single tax year. This exemption from capital gains tax is available for "qualifying disposals" by persons other than a company made to an EOT on or after 6th April, 2014.
- The exemption is available for persons who are not companies and, provided the set statutory requirements are met, notably that the shares are in a trading company or the parent company of a trading group, then the capital gains tax exemption is available to an unlimited extent. The fact that the exemption is unlimited is a very attractive feature indeed, even if the vendor has access to Entrepreneurs Relief for the simple reason that the sale of the shares to the EOT attracts zero capital gains tax on an unlimited amount.

B. Income Tax Exemption: Qualifying Bonus Payments

- A complete exemption from income tax for employees on bonuses paid up to £3,600 per tax year by a company that is owned by an EOT to all "qualifying employees" on a basis that meets the definition for "same terms". This exemption from income tax is effective for bonus payments that are made on or after 1st October, 2014.

Employee Share Ownership

All Best Wishes For Your Business Initiative From David Craddock

Consultant, Lecturer, Author

and Specialist in Employee Share Schemes and Reward Management, Management Buyouts, Share Valuation and Investment Education

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David Craddock Consultancy Services
Telephone: 01782 519925
Mobile Phone: 07831 572615
E-mail: D.Craddock@dcconsultancyservices.com
Website: www.DavidCraddock.com

Questions & Comments

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Resources – "It's Our Business"

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The Esop Centre's *newspad*, edited by Fred Hackworth, is a monthly publication providing in-depth coverage of the main international news in the employee share ownership field.

June 2020

In this month's edition:

- Centre backs mission for underwater SAYE schemes
- Record shareholder revolt over
- gambler's ceo reward
- Lloyds Bank in the Sin Bin over executive bonus plan
- It's raining bonuses at Tesco
- Employee share awards: an antidote to Covid-19?

it's our business

newspad of the Employee Share Ownership Centre

Tidal wave of MBOs engulfs C.I. trust companies

Resources – Bulletins

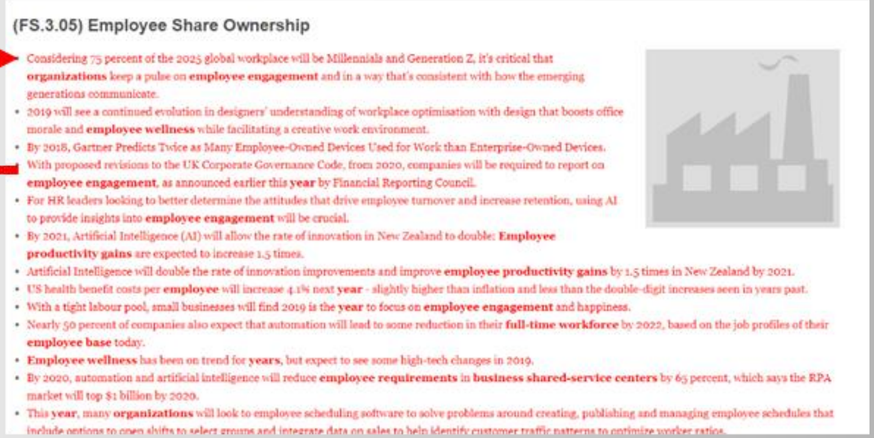
EspopCentre

From 43,000 curated sources, you get a machine summary of the key point(s) from forward-looking articles, not just article titles:

(LF.10) Reduced Inequalities

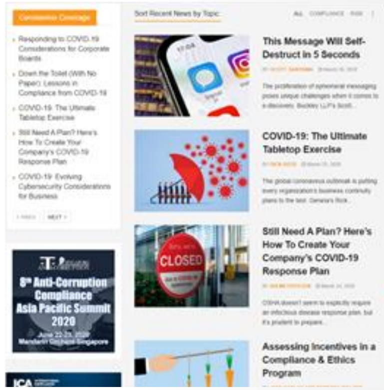
In September 2015, 193 world leaders agreed to 17 Global Goals for Sustainable Development. If these Goals are completed, it would mean an end to extreme poverty, inequality and climate change by 2030.
Goal 10: Reduce inequality within and among countries.

- If the distributions of **income**, means-tested transfers, and federal taxes follow CBO's projections, **income inequality** will be greater in 2021 than it was in 2016.
- **High growth** over the **past decade** has been based on unsustainable resource exploitation; addressing the **resulting growth** in **inequality** and environmental cost will be critical to ensure social stability and to ensure **strong sustainable growth** in the coming decade.
- The increase in **inequality** observed in the last 30 years is a serious threat to France's social contract.
- America's pluto-populist president is peddling a tax plan that will further increase **economic inequality** at a time when **income** and wealth gaps are already widening.
- A failure to give the **world's poorest women control** over their bodies could widen **inequality** in **developing countries** and thwart progress towards global goals aimed at ending poverty by 2030.
- Under French leadership the G7 group of the 7 largest advanced economies plus the European Union will focus in 2019 on fighting **inequality**, including **poverty** induced by **climate change**.
- Leadership might require companies to take positions and advocate for **change** on **global inequality** - including **in-work poverty**.
- Achieving the 17 **Sustainable Development Goals** - which include clean water, clean energy, sustainable cities, climate action, responsible consumption, **reduced inequality** and more - could open a market opportunity of $12 trillion by 2030.
- The next decades offer an opportunity to address **African urban poverty** and **inequality** and shape development priorities to ensure that urbanisation helps foster well-functioning, liveable and sustainable cities.
- In Africa and in the LDCs, eradicating poverty by 2030 will require both **double-digit GDP growth** and dramatic declines in **inequality**, illustrating the scale of the current challenges faced.
- The economic catch-up of Asia with the West will continue in the coming decades - thereby reducing **global inequality** among countries and among world citizens.



(FS.3.05) Employee Share Ownership

- Considering 75 percent of the 2025 global workplace will be Millennials and Generation Z, it's critical that **organizations** keep a pulse on **employee engagement** and in a way that's consistent with how the emerging generations communicate.
- 2019 will see a continued evolution in designers' understanding of workplace optimisation with design that boosts office morale and **employee wellness** while facilitating a creative work environment.
- By 2018, Gartner Predicts Twice as Many Employee-Owned Devices Used for Work than Enterprise-Owned Devices.
- With proposed revisions to the UK Corporate Governance Code, from 2020, companies will be required to report on **employee engagement**, as announced earlier this **year** by Financial Reporting Council.
- For HR leaders looking to better determine the attitudes that drive employee turnover and increase retention, using AI to provide insights into **employee engagement** will be crucial.
- By 2021, Artificial Intelligence (AI) will allow the rate of innovation in New Zealand to double: **Employee productivity gains** are expected to increase 1.5 times.
- Artificial Intelligence will double the rate of innovation improvements and improve **employee productivity gains** by 1.5 times in New Zealand by 2021.
- US health benefit costs per **employee** will increase 4.1% next **year** - slightly higher than inflation and less than the double-digit increases seen in years past.
- With a tight labour pool, small businesses will find 2019 is the **year** to focus on **employee engagement** and happiness.
- Nearly 50 percent of companies also expect that automation will lead to some reduction in their **full-time workforce** by 2022, based on the job profiles of their **employee base** today.
- **Employee wellness** has been on trend for **years**, but expect to see some high-tech changes in 2019.
- By 2020, automation and artificial intelligence will reduce **employee requirements** in **business shared-service centers** by 65 percent, which says the RPA market will top $1 billion by 2020.
- This **year**, many **organizations** will look to employee scheduling software to solve problems around creating, publishing and managing employee schedules that include options to open shifts to select groups and integrate data on sales to help identify customer traffic patterns to optimize worker ratios.



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03 July 2020 (14:00)	News In A Time Of Covid-19 / Physical Features Of Global Business Centres
06 July 2020 (12:00)	CCPs – Crises, Risks, Resolutions
07 July 2020 (09:00)	Corporate Governance – Why Your People Are Your Board's Biggest Problem
08 July 2020 (11:00)	Beyond Investing: A Frontier Of Positive Change
09 July 2020 (10:00)	Awarding Shares To Employees In A Covid-19 World

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